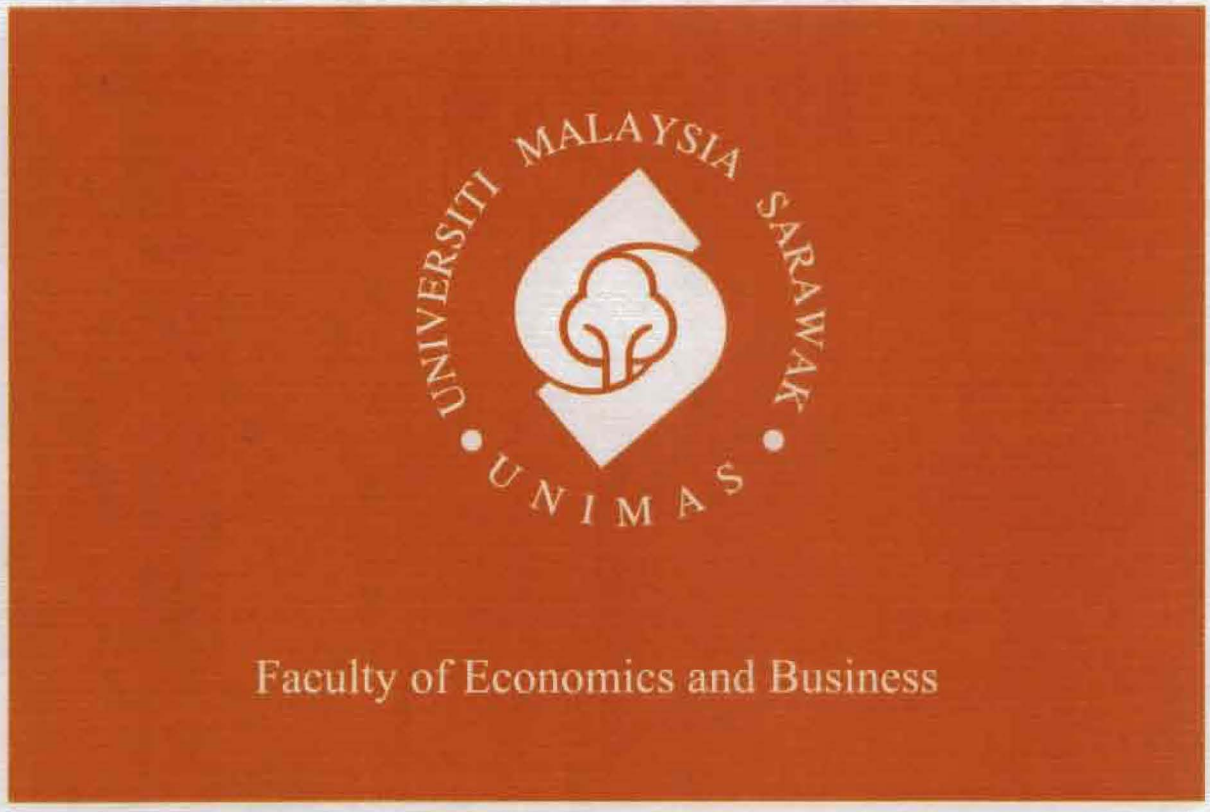

DOES MALAYSIAN FIRMS' CORPORATE CAPITAL STRUCTURE CHANGE HAVE AN IMPACT ON ITS CORPORATE PERFORMANCE?

Teoh Ker Li

Bachelor of Finance (Honours)
2012

ADAKAH PERUBAHAN STRUKTUR MODAL KOPORAT FIRMA-FIRMA DI MALAYSIA MEMBERI KESAN KEATAS PRESTASI KOPORATNYA?

TEOH KER LI

Projek ini merupakan salah satu keperluan untuk
Ijazah Sajarna Muda Kewangan dengan Kepujian

Fakulti Ekonomi dan Perniagaan
UNIVERSITI MALAYSIA SARAWAK
2012

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TEOH KER LI

This project is submitted in partial fulfilment of the requirements for the degree of
Bachelor of Finance with Honours
(Finance)

Faculty of Economics and Business
UNIVERSITI MALAYSIA SARAWAK
2012

PENGESAHAN PELAJAR

Saya mengakui bahawa Projek Tahun Akhir bertajuk
Adakah Perubahan Struktur Modal Koporat Firma-Firma di Malaysia Memberi Kesan ke atas Prestasi Koporatnya?
ini adalah hasil kerja saya sendiri kecuali nukilan, petikan, huraian dan ringkasan yang tiap-tiap satunya telah saya nyatakan sumbernya.

25/06/2012

(Tarikh Serahan)

(Tandatangan Pelajar)
Teoh Ker Li
25699

STATEMENT OF ORIGINALITY

This work described in this Final Year Project, entitled
Does Malaysian Firms' Corporate Capital Structure Change Have an Impact on Its Corporate Performance?
is to the best of the author's knowledge that of the author except where due reference is made.

25/06/2012

(Date Submitted)

(Student's Signature)
Teoh Ker Li
25699

ABSTRAK

ADAKAH PERUBAHAN STRUKTUR MODAL KOPORAT FIRMA-FIRMA DI MALAYSIA MEMBERI KESAN KEATAS PRESTASI KOPORATNYA?

oleh

Teoh Ker Li

Kajian ini bertujuan mengkaji hubungan yang wujud dalam tahun-tahun yang berlainan di antara struktur modal dan prestasi koporat dengan menggunakan 505 buah firma yang tersenarai di Bursa Malaysia. Kajian ini telah dijalankan dengan menganalisasikan kesan nisbah corak perubahan hutang dan ekuiti dalam 505 buah firma yang terpilih dari tahun 2005 hingga 2010 dan menentukan hubungan tersebut sama ada menyokong teori *Static Trade-off* atau teori *Pecking Order*. Tempoh kajian ini adalah dijalankan dalam bentuk keseluruhan serta dalam keadaan ekonomi yang berbeza, terutamanya dalam keadaan ekonomi yang mengalami krisis. Perubahan jumlah hutang, jumlah hutang jangka panjang, jumlah hutang jangka pendek dan jumlah ekuiti digunakan sebagai proksi stuktur modal manakala pasaran nilai buku, margin untung bersih serta pulangan ekuiti telah digunakan sebagai pengukuran prestasi koporat. Keputusan kajian menunjukkan hanya jumlah ekuiti didapati mempunyai hubungan positif yang kukuh terhadap semua ukuran prestasi koporat. Pada masa yang sama, hubungan antara semua jenis perubahan hutang dengan petunjuk-petunjuk prestasi koporat adalah dalam bentuk yang bercampuran. Secara keseluruhan, kebanyakkan hubungan antara perubahan struktur modal firma dengan perubahan prestasi koporat didapati mengikuti teori *Static Trade-off*.

ABSTRACT

DOES MALAYSIAN FIRMS' CORPORATE CAPITAL STRUCTURE CHANGE HAVE AN IMPACT ON ITS CORPORATE PERFORMANCE?

by

Teoh Ker Li

This study aims to examine the relationship that exists to be varying year by year between the corporate financial structure in debt and equity ratio change pattern of movement that affects the performance of the selected 505 public listed firms in Malaysia from year 2005 to 2010 and determines its consistency in related to either static trade-off theory or pecking order theory. It is tested in overall and also different economic period mainly the crisis period by using change of total debt, long term-debt, short-term debt and total equity as the proxy corporate financial structure. Whereas for the measurement of corporate performance will be using Market to Book Value, Net Profit Margin and Return on Equity. Results show that only change in total equity had a consistent positive significant relationship with the change of all corporate performance indicators, whereas a mix relationship was found between all kinds of change in debts with the change of all corporate performance indicators. In overall, majority of the relationships between changes in corporate financial structure with change of corporate performance was found consistent with the Static Trade-off Theory.

ACKNOWLEDGEMENT

First of all, I would like to offer my sincerest gratitude to my thesis's supervisor, Madam Josephine Yau wholehearted guidance, invaluable help, encouragement, advises and patience for all aspect from this thesis progress. Her numerous comments and suggestion during the preparation of this project are gratefully praised. Especially for her patience and unconditional willingness in help when encountering problem no matter big or small during the thesis progress is invaluable and truthfully well appreciated. I attribute the level of my degree to her encouragement and effort and without her this thesis, too, would not have been completed. One simply could not wish for a better or friendlier supervisor.

Upon completion of this thesis, I would also want to thanks my mother and family for their constant support mentally and financially from the beginning of the thesis progress. Finally, I would like to thanks to my thesis group mates, house mates that helped and supported me a lot especially Bong Hui Hian and Chua Su Yen who happily cooperated as thesis group mates in solving all problems that occurred during the thesis program especially in the process of collecting data. Lastly, I would like to thank my house mates and friends who helped and supported me throughout the thesis progress.

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CHAPTER ONE

INTRODUCTION

1.0 Introduction

Financial structure can be defined as the mixture or the combination of debts and equity which are used to support and finances the firm's total assets where it usually determined by the financial manager in an organization. Financial structure is usually consists of long-term debt, short-term debt and also the total equity of a firm (Brealey, Myers, & Allen, 2008), and can be found in the right hand side of a firm's balance sheet to financed the usage of total assets in a firm which can be found in the left hand side of the balance sheet (Ross, Randolph, & Jeffrey, 1999).

Capital structure, another similar term for financial structure, yet there are many differences found between both. Actually, capital structure is somehow a subset of financial structure as it is only the summation of the total long-term sources of capital, which consist of many different type of long-term debt, and at least two type of equity(common and preferred stock) and also hybrid(convertible bonds) (Saad, 2010). Since the term of financial structure and capital structure are more or less having the same meaning in most research paper, therefore in this research paper terms financial structure and capital structure will be assume as the same definition.

Over half of the century, it had been a favourite and popular topic among the academicians and practitioners in the finance field to discussed and begin their researches based on the scope of capital structure and corporate performance which is the fundamental topic of corporate finance ever since the path breaking

contribution by Modigliani and Miller (MM) in developing the irrelevance proposition of the modern capital structure theory (Chou, et.al. 2010; Cheng, Liu, & Chien, 2010). Modigliani and Miller (1958) popularly known as the MM theorem or also known as the irrelevance theory of capital structure is the origin theory of capital structure that is broadly accepted and in used by many researchers which implies that capital structure or the financing decision of a firm give no effect to firm's value in a perfect market (Ong & Teh, 2011).

For years in many studies around the world tried to find out an ideal way to achieved optimal capital structure where firm's weighted average cost of capital is minimized and maximizing the corporate performance on the other hand (Tian & Zeitun, 2007). Just like the probability chart, a large scale of distinct securities in uncountable combination can be issued by the firm's financial manager based on the principle of a firm's most basic objective, maximizing the corporate profitability (Brealey, Myers, & Allen, 2008).

Profit alone had no longer a significant meaning to firm albeit it is tried to be maximized all the time. Many financial managers thought that it is not a well defined tool for firm objective anymore. Now in modern days, most of the time financial manager attempt to obtain a particular combination that can contribute to increase the firm's overall market value (Altan & Arkan, 2011) as increasing the corporate performance had gradually become the main focus of firms' value. Hence, it is important for a financial manager to decide how the firm finances its overall functions and growth by using different source of funds (Ong & Teh, 2011).

However, in today's rapidly growing capital market it is difficult for financial manager to distinguish a perfect ratio of optimal capital structure for a firm. In fact, there is no definite way or formula in determining optimal firm's capital structure neither in a perfect market nor imperfect market (Dhankar & Boora, 1996). Since the market in reality are imperfect, then there is a possibility that capital structure that a firm used might cause corporate performance to be vary from time to time as capital structure does has a closed link with corporate performance (Tian & Zeitun, 2007; Ong & Teh, 2011).

The following table presented the formation of a firm's financial structure in the balance sheet of a firm. Where on the left hand side, comprise from the type of long lived assets that a firm should invest, known as capital budget. While on the right hand side is the method of a firm obtained to raise cash for required capital expenditures in whole, known as capital structure. This is where many finance managers are trying to seek for a balance or optimum capital structure between debt financing and equity financing in order to achieve the objective of corporate performance maximization.

Table 1.1: Components of financial structure in a non-financial firm

From the table here, it is clearly shown that the total debt and equity of a firm from the left side of the balance sheet are used to finance the total assets of the firm from the right side of the balance sheet.

Firm's Balance Sheet	
Assets:	**Liabilities and Equity:**
Fixed Assets	**Long-Term Liabilities**
Buildings	Long-term notes
Land	Long-term bonds
Machinery and Equipment	Long-term bank loans
	Debentures
	Pension Obligation
	Lease Obligation
Total Fixed Assets[1]	**Total Long – term Liabilities[4]**
Current Assets	**Short-Term Liabilities**
Inventories	Short-term Notes
Cash in hand	Overdraft
Cash in Bank	Account Payables
Account Receivables	Accrued Expenses
Prepaid Expenses	Other Payables
Marketable Securities	Deferred Tax
	Unearned revenues, Deposits
Total Current Assets[2]	**Total Short – Term Liabilities[5]**
Other Assets	**Equity:**
Patents	Common Stock
Copyrights	(Par value + Paid in Capital
Investments	– Treasury Stock)
Goodwill	Preferred Stock
	Capital Reserves
	Retained Earnings
Total Other Assets[3]	**Total Equity[6]**
SUM:	**SUM:**
1+2+3= Total Assets	**4+5+6= Total Debt and Equity**

Source: Above table was an example of balance sheet adapted and modified from the Corporate Finance McGraw-Hill International Edition, pp.2 and also from the Financial Management: Principles and Applications Pearson Prentice Hall International Edition, pp.35

1.1 Theoretical Framework

The relationship between financial structure and corporate performance can be tested based on various theories. Modigliani and Miller's (1958) MM Theorem, the first modern theory of capital structure which also the elemental theory of capital structure. Another theory is the static-trade off theory which is use to determine the capital structure value by a trade-off between tax shield and bankruptcy cost. While the Pecking Order Theory by Myers and Majluf (1984) will be the choice of testing the capital structure of using the internal financing when the firm internal financing is inadequate. A Signalling theory of capital structure can also be used to explain the relationship between capital structure and corporate performance. Lastly the theory can be related in testing the link between the capital structure and firm performance will be the Agency theory.

1.1.1 Modigliani and Miller (MM) Theorem (1958)

Since 1958, Modigliani and Miller had developed a theory pertaining the firm capital structure and corporate performance which known as the Modigliani and Miller theorem, in short MM theorem. MM theorem is someway been said that it is a foundation of modern corporate finance. The starting point of the theory for capital structure having the basic concept where firm which are operate in a well-function market, its financial decisions do not give any effect to corporate performance (Villamil, 2008).

From the studies had done by Modigliani and Miller, there are four different outcomes that can found from their papers in 1958, 1961 and 1963

where there are four propositions established based on their studies (Villamil, 2008). The first proposition of the MM theorem was about under a certain conditions, the pattern of consumption on debt and equity of a firm does not give an effect to the firm's market value. While the second proposition of MM Theorem stated that a firm's leverage will not affect the firm's weighted average cost of capital (Pagano, 2005). The third proposition of MM Theorem was focused on the firm market value stated that it will not be affected by its dividend policy. And the fourth proposition of the MM theorem found that the reaction of the equity-holders is unresponsive towards the firm's financial policy. MM theorem had been characterized as one of the first formal theories that use the concept of a no arbitrage case where the thought of "law of one price" is venerable (Villamil, 2008).

This theory is function under a perfect market where it is operates under a few assumptions applied by Modigliani and Miller (1958). The assumptions are in a perfect market which means there will be neutral taxes, no capital market frictions, no asymmetric privilege for the investors and the borrowers, and firm financial policy provides no information where the market is efficient (Modigliani & Miller, 1958). This is why the MM theorem is somehow structured a debate on why it had been known as the capital structure irrelevance theory as the market in the modern days are no long perfect (Jensen & Meckling, 1976; Modigliani & Miller, 1963; Myers, 1984; Myers & Majluf, 1984).